DISTRIBUTION NETWORKS PRICING CONSULTATION REPORT ON DNPC05

Methodology for Determining the Balance of Revenue Recovery between LDZ System Charges and Customer Charges

1. The Proposal

The present methodology for setting the balance of LDZ System and Customer charges is designed to reflect the balance of costs to which these charges relate. At present, this is based on analysis undertaken several years ago on a national basis across all LDZs. Recent cost analyses by the DNs indicate that the proportions of LDZ System and Customer costs each of them incur differ between the DNs.

The DNs issued a consultation, DNPC05, on 21st October 2009 setting out their proposals concerning these activities and invited comments from the shipper community in accordance with DN's Licence Standard Special Condition A5.

In DNPC05, the DNs proposed that the target balance of revenue recovery between the LDZ System and Customer charges within each DN should be based on a DN-specific assessment of the split of the relevant costs and that this assessment should be determined based upon the average split over an appropriate number of years for which data on a consistent basis is available. It was also proposed that the target balance of revenue recovery should be reviewed at the start of each new Price Control period, except in exceptional circumstances.

Respondents were also asked to consider whether there are any reasons why the proposal should not be implemented from 1 April 2010.

The primary purpose of the proposal was to amend the charging methodology so as to improve the cost reflectivity of DN transportation charges in accordance with DN's Licence Standard Special Condition A5.

2. Summary of Responses

There were 9 responses to the consultation: 5 from shippers/suppliers, 3 from independent gas transporters (iGTs) and one confidential response.

Shippers/Suppliers	
British Gas	BG
EDF Energy	EDF
E.ON UK	EON
Scottish Power	SP
RWE	RWE
Independent Gas Transporters	
ES Pipelines	ESP
Energetics Gas	ENG
GTC	GTS
Confidential Response	

The responses are summarised below based on the questions for consultation in the original paper. The Confidential Response did not support the proposals in the consultation document and further did not directly address the consultation questions; the DNs' response to the issues raised is in a separate document, confidential to Ofgem and the respondent.

3. Question 1. Should the methodology for determining the balance of revenue recovery between LDZ System charges and Customer charges be changed from the current national basis to a DN specific estimate of the split of the relevant costs?

3.1 Summary of Responses Received

Five shippers (BG, EDF, E.ON, RWE, SP) and two iGTs (GTC, ESP) supported the proposal to adopt network-specific splits of the relevant costs on the basis of improved cost reflectivity for individual DNs.

BG supported network-specific cost splits but also noted that an update of the common national split, based on the latest data, would be more cost reflective than the current split.

EDF and BG noted that as DNs already have network-specific charges and shippers have systems and processes in place to support such charges, there would be no process and system issues for shippers and suppliers.

One iGT (ENG) did not support this change on the basis that they felt the consultation did not address the costs of facilitating and managing the change. They also considered that the consultation failed to properly consider concerns regarding volatility in charges and the additional complexity of network specific splits.

3.2 DNs' Responses

DNs believe that network-specific cost splits would improve the cost reflectivity of the charging methodology. Given that each DN has a Licence obligation to develop a charging methodology that results in charges *which reflect the costs incurred by the licensee in its transportation business* we consider that there is a clear need for each DN to adopt a target revenue split based upon analysis of its own costs.

We do not consider that there are any significant costs to introducing the change – as some respondents have noted, DNs already have network-specific charges and shippers have systems and processes in place to support such charges. Under the proposal, the target network splits would be set until next reviewed at the start of the next Price Control period and so there should be no ongoing volatility in DNs' transportation charges due to the methodology change.

4. Question 2. Should the balance of costs relating to LDZ System and Customer charges be assessed using an average of an appropriate number of years for which data on a consistent basis is available for each network? An alternative would be to use the cost analysis for just the latest year available.

4.1 Summary of Responses Received

Three shippers (EDF, SP, EON) and three iGTs (GTC, ENG, ESP) supported basing the assessment on an average of an appropriate number of years. EDF noted that this would minimise the impact of fluctuations from year to year. SP considered that the use of an average was more appropriate than using a single year's data since there may be unique issues particular to one year. EDF considered that arguably it would be beneficial to use 5 years data rather than just 2 years' data. However, using the 2 year average was more cost reflective than using the current split based on data from 2003. Although EON supported the use of an average, they thought that a 2 year average was not robust and using just the last year's data or delaying implementation, so as to obtain more years' data, were alternatives. GTC and ESP also thought that the use of a 2 year average could produce atypical results compared to the actual long term costs and that the marked fluctuation in the cost splits demonstrated this. They considered that established regulatory practice is to use 5 years' data as a minimum. ENG also thought that a 2 year average would not smooth out any major fluctuations resulting from extreme winter temperatures or volatile gas prices.

Two shippers (BG, RWE) supported using just the latest year's data rather than an average of a number of years. Both noted that the basis of National Grid's data significantly changed for 2008/09 (due to a change in the asset life assumption) and so it was more appropriate to base the split on just the 2008/09 data.

4.2 DNs' Responses

DNs believe that there is a benefit in using an average derived from data for a number of years so as to reduce the effect of particular issues impacting for a single year. Using just the latest year's data would seem to be more appropriate if the split were to be updated each year, so that the data for each year is utilised consistently but only for a year; however this approach would introduce unwelcome variability into the split from year to year, making it more difficult to forecast the balance of charges. Under the proposal to set the target split at this time and to review it only at the start of the next price control period, the DNs consider that, on balance, it is preferable to use an average over a number of years where consistent data is available.

The DNs recognize that using just 2 years' data is not a perfect basis for determining the appropriate ongoing split but consider that it is preferable to using data from as long ago as 2003 and more accurately reflects the costs incurred by the licensees in their respective transportation businesses. However the DNs consider that the benefits of introducing target revenue splits which reflect network-specific costs as soon as possible significantly outweigh the benefit of waiting a further year to obtain another year's data and implementing the change a further year later.

5. Question 3. Should the balance of charges relating to LDZ System and Customer charges be reviewed at the beginning of each Price Control period, except in exceptional circumstance?

5.1 Summary of Responses Received

Four shippers (EDF, SP, EON, RWE) and three iGTs (GTC, ENG, ESP) supported reviewing the balance of charges at the start of each Price Control period or every 5 years, with the benefits of stability and predictability of charges mentioned by some respondents. EDF considered that the review could be done at the start of each Price Control period or alternatively when Seasonal Normal Demand was re-set. EDF suggested that, in order for DNs to ensure that charges were still cost reflective, the split could be re-set if it diverged by more than a tolerance, which they suggested to be at least 3%. They suggested that DNs could inform industry parties on changes to their cost structures, possibly through the Mod 186 report, so as to aid the visibility and predictability of charges. GTC thought that only changes beyond a certain tolerance should be made in order to avoid onerous minor changes. RWE believed that the next review should utilise each year's data from 2008/9 onwards but with a greater weighting on the most recent years' data. They also thought that exceptional circumstances should be explicitly defined where possible and that any future changes should be notified well in advance of implementation.

One shipper (BG) considered that, since annual rebalancing changes were likely to be relatively small, annual changes were preferable to a larger step change at the next price control and this would be more cost-reflective. The need for visibility and advance notice of changes was also stressed.

5.2 DNs' Response

DNs agree that it is appropriate to carry out a cost analysis review following the Price Control and that charges should be rebalanced with updated cost splits. It would seem more appropriate to carry out the review at the start of each Price Control period rather than when Seasonal Normal Demand is reset since the SND review has no interaction with the cost base.

The DNs consider that the benefits of predictability from having a known target revenue split outweigh any benefits arising from introducing pre-set tolerances for when the split would be changed.

The DNs consider that annual rebalancing of the target revenue balance of charges would impact detrimentally on the forecastability of charges. Whilst this approach would enable the charges to better reflect the immediate preceding year's cost balance it would also be likely to introduce fluctuations from one year to the next which would not necessarily better reflect the ongoing balance of costs.

The DNs consider that it is not appropriate to only make changes to the target splits beyond a set threshold at a 5 year review since the implementation of small target split changes, when transportation charges are revised anyway, is not onerous. The rationale for reviewing only at 5 year intervals is to provide greater certainty in the intervening years.

6. Question 4. Is there any reason why the proposal should not be implemented from 1st April 2010?

6.1 Summary of Responses Received

Four shippers (BG, RWE, EDF, SP) said there was no reason why the proposal should not be implemented from 1 April 2010. BG and EDF noted that no update has taken place since 2003 and so there were strong grounds for making the change at this time. They both further noted that the initial consultation on the change was in October 2008 and so all industry stakeholders should already be familiar with the issues and direction of change. EDF thought that the correct targeting of costs would be beneficial to competition by ensuring that there is no cross subsidy between market sectors. SP support for April 2010 implementation was conditional on confirmation of the changes by 1st February 2010; if this could not be achieved then they would prefer to delay a further year rather than make a change at an interim time.

One shipper (EON) thought that there may be merit in delaying implementation to enable further years' data to be included in the determination of the split.

Three iGTs (GTC, ENG, ESP) believed that the change should not be implemented at April 2010. ENG considered that the proposals should not be implemented until all their concerns, including the impact of the change on iGT charges under the Relative Price Control licence condition, had been resolved. ESP thought that the change should be delayed until the start of the next Price Control, giving consistency with the review timescale.

6.2 DNs' Response

The majority of respondents support implementation from April 2010. As noted by some of the respondents, since the initial consultation on this issue in 2008 industry stakeholders have had a lengthy period to prepare for the change.

Although the data period used to establish the target split is less than a perfect solution the DNs consider that the benefits of introducing target revenue splits which reflect network-specific costs as soon as possible outweigh the benefit of waiting a further year to obtain another year's data and implementing the change a year later.

The DNs expect that confirmation of any change would be provided by 1st February 2010.

Some iGTs have confirmed that the methodology change will not have an immediate impact on their iGT charges for existing sites within iGT networks and will only immediately impact on iGT charges for new sites connected after implementation of the change. Since any impact on iGT charges for the large majority of sites within iGT networks would be some years away this would seem to allow appropriate time for any discussions which iGTs consider that they need with Ofgem.

7. Other Issues Raised

7.1 Impact of the proposal on iGTs and their Relative Price Control (RPC)

EDF thought that the impact of the change in methodology on RPC might not be within the scope of the consultation required by standard Licence Condition A5. However, they considered that, given that the iGTs would have 12 months from implementation until the change impacted on iGT charges, this provided sufficient time for iGT and Ofgem to address this issue.

GTC expressed disappointment at the short consultation period, the lack of engagement with iGTs, and that a detailed impact assessment of the changes on iGTs, Shippers to CSEPs and competition had not been undertaken. GTC and ESP stated that the change would have an impact on iGT charges for shippers prior to 1 January 2011 because it would impact on CSEP costs. They stated that the iGT margin remains unchanged under the RPC and Legacy arrangements but the increase in DN's transportation charges to CSEPs would lead to higher transportation costs for shippers.

GTC also considered it unacceptable that iGTs should expense higher DN revenues at the expense of lower iGT margins and believed the proposals could have a detrimental impact on consumers. GTC and ESP stated that currently iGT charges for RPC sites are in the majority of cases considerably less than the for equivalent DN directly-connected sites because of the operation of the RPC cap and collar arrangements. ESP noted that the impact on iGT prices from January 2011 would be limited by the fact that the vast majority of existing RPC prices across all regions have hit the ceiling defined under the RPC control.

GTC and ESP considered that, since the change would impact on the point at which revenue neutrality would occur for legacy connections due to migrate to RPC after 2014, the proposals could potentially lead to some iGTs seeking to adjust migration dates for legacy connections.

ESP noted that for iGT legacy networks migrating to RPC before 2012 there would not be a recalculation of migration dates or prices; the proposed changes would mean that a tier of "legacy RPC" charges would be created adding uncertainty and complexity for shippers instead of the intended simplicity.

GTC and ENG stated that the proposals would impact on iGT charges under RPC for new supply points connected after implementation of the change, from April 2010 under the proposal.

GTC had undertaken initial analysis regarding the potential impact on GTC revenues from which they have significant concerns that the proposal constitutes a "margin squeeze" which they felt was in direct contravention of competition law. ESP noted that they would enjoy generally lower margins with the margin squeeze most evident on smallest iGT networks. ESP thought it appropriate to ask whether a competition test has been carried out on the proposed changes.

ENG considered that the methodology change would in effect move the gas regime closer to the electricity DNO model. They thought that the complexity and variability of the DNOs' use of system charges was one of the major contributory factors to the lack of competition in the electricity sector.

7.2 DN Response

These proposals have been developed in the context of the obligation set out in DNs' gas transporter licences to develop charging methodologies which result in charges which reflect the costs incurred by the licensees in their transportation businesses (see Standard Special Condition A5 (Obligations as regard Charging Methodology) at paragraph 5(a)): they have been brought forward in the light of robust analysis of DNs' costs on a network-by-network basis and, as such, the DNs consider them to be entirely appropriate in the context of all of the DNs' regulatory and legal obligations. In the event that these costs potentially raise issues for iGTs' ability to develop their networks in the future as a result of the operation of the RPC (which is a point that the DNs do not accept), these are issues which seem to the DNs to be more appropriately addressed through a discussion of the operation of the RPC between the iGTs and Ofgem, rather than through adjusting the split of cost allocations used to derive DN charges.

While the DNs do not consider it is appropriate for them to consider the impact on iGT regulation and iGT charges directly, the DNs recognise that the Authority may wish to consider the impact of a change to the methodology on iGT charges and iGT regulation. In order to assist the Authority in this assessment, each of the DNs has estimated the impact of the proposal on the iGT margin for iGT developments, of different sizes, consisting entirely of domestic properties. These estimates have been provided separately by each DN to Ofgem. The DNs are however aware that their development of these estimates was limited because the DNs are not in a position to model all aspects of the impact of the RPC because of a lack of relevant information, and in particular the impact of the caps and collars on individual iGT charges. That said, we note that an iGT respondent, GTC, stated that, due to the operation of the RPC cap and collar, its revenues would not be significantly impacted by the proposals on average although they could be impacted in future.

No evidence has been produced by GTC to suggest that a reduction in revenues that future projects face will prevent them developing their networks profitably through continuing to compete effectively in the provision of new connections in the future.

The paper stated that the proposals should have no impact on iGTs' own charges prior to January 2011. We note that the proposals could have an impact on iGT charges under RPC for new supply points connected after April 2010 but these would be a small minority of all iGT sites. A full analysis of the impact on transportation charges to CSEPs was included within the consultation paper. GTC and ESP stated that the iGT margin remains unchanged under the RPC and Legacy arrangements; since the overall level of transportation charges would be unchanged by the proposal then there would be no overall impact on DN transportation charges and so no detrimental impact on consumers in general. There would be some rebalancing of DN transportation charges as highlighted in the consultation paper.

DNs maintain that charges have been based on an accurate and fair allocation of their total costs, as summarised in the appendix to the consultation paper. As a result, DNs do not believe that updating their charging methodology in line with the cost structures of their specific networks, in the light of robust analysis of those costs structures, can lead to any breach of competition law. Indeed, as noted above, DNs consider that the proposed changes are compliant with the requirements of their gas transporter licences.

With regard to iGT legacy networks migrating to RPC prior to 2014, the DNs fail to see how the proposed changes would add uncertainty or complexity for shippers since presumably it is felt that general changes to DN transportation charges prior to 2014 will lead anyway to variations in these migrated iGT network charges from other networks entering RPC at the same time. We note that none of the shipper respondents commented on this as an issue for them.

While not required to do so by their licences, given the impact on shipper costs resulting from iGT charges, DNs have made efforts to inform, include and act upon feedback consistently from all market parties impacted.

The DNs believe that the methodology change would not move the gas regime closer to the current electricity distribution model since there would continue to be a common methodology across the gas distribution networks and the gas distribution charges would not be more complex than currently. Rather, DNs understand that changes in the electricity regime regarding the introduction of a common methodology across DNOs will bring the electricity regime closer to the gas model.

In any event, as discussed in the next section, the DNs believe that the proposed methodology better meets the requirements to have a charging methodology that results in charges which reflect the costs incurred in their respective transportation businesses.

8. Objectives of the Charging Methodology

Any change to the charging methodology should be considered in the light of the achievement of the objectives of the charging methodology, set out in Standard Special Condition A5 of the Gas Transporter Licence. The relevant objectives are:

(a) That compliance with the charging methodology results in charges which reflect the costs incurred by the licensee in its transportation business;

(b) That, so far as is consistent with (a), the charging methodology properly takes account of developments in the transportation business;

(c) That, so far as is consistent with (a) and (b), compliance with the charging methodology facilitates effective competition between gas shippers and between gas suppliers.

(a) Cost Reflectivity

The DNs consider that the proposal for each DN's split to be based on DN-specific data would improve cost reflectivity and that the use of an average across a number of years' cost analysis would provide a robust analysis that reduces the dependence on the costs for a particular year.

Seven of the respondents agreed that the determination of revenue splits between LDZ System and Customer charges for each DN based upon cost analysis particular to each DN would improve the cost reflectivity.

Six of the respondents thought that it was appropriate to use an average across a number of years' cost analysis. However, four of the six respondents supporting the use of an average thought that a two year average would not give robust results.

Two respondents preferred to use just the latest year's cost data. However one of these supported implementation at April 2010 based upon the cost data in the consultation, whichever of the approaches was used, rather than delay implementation further.

(b) Take account of developments within the transportation business

The DNs consider that a move to DN specific revenue recovery apportionment would reflect the fact the gas distribution business now consists of eight different networks each with its own cost structure.

No respondents mentioned this objective in their response.

(c) Facilitating Competition

The DNs believe that the proposed change would provide greater certainty on the split of revenue between the LDZ System and Customer charges and that this greater certainty would facilitate competition in gas supply.

Only one respondent (ESP) mentioned this objective in their response. They thought that although the proposal would give greater certainty that the balance of charges will change, and when, it would not provide greater certainty of the actual transportation charges and so would not facilitate competition in gas supply.

9. Final Proposals

a) **The charging methodology will be changed so that:**
   i. **The target balance of revenue between LDZ System charges and Customer charges for each DN is based upon a network-specific estimate of the split of relevant costs; and**
   ii. **The network-specific estimate of the split of relevant costs will be assessed using an average of an appropriate number of years for which data on a consistent basis is available for each network;**

b) **The target balance of revenue between LDZ System and Customer charges will be reviewed at the beginning of each Price Control period, except in exceptional circumstance;**

c) **The changes should be made with effect from 1 April 2010; and**

d) **For the implementation of the change at 1 April 2010 the network-specific assessment of the split of relevant costs will be based on an average of 2 years' data, 2007/8 and 2008/9. The target revenue splits will be as shown in the Table below. The splits for Scotland and Southern England have changed marginally due to an update since the publication of DNPC05.**

	LDZ System Average	Customer Average
East of England	70.5%	29.5%
London	68.1%	31.9%
North West	73.7%	26.3%
West Midlands	74.0%	26.0%
Scotland	71.1%	28.9%
Southern England	72.6%	27.4%
Northern England	71.2%	28.8%
Wales & West	71.8%	28.2%
Average	**71.6%**	**28.4%**